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October 11, 2012

Re: Request for Private Letter Ruling Regarding §§ 167 and 168

LEGEND

Taxpayer =

Subsidiary =

Transmitter =

State =

Location =

Region =

Project =

Subsidiary Line =

Transmitter Line =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

K =

L =

M =

N =

O =

Dear :

This letter responds to a letter dated April 19, 2012, and subsequent correspondence, submitted on behalf of Taxpayer and Subsidiary, requesting a private letter ruling that certain circumstances will not prevent each wind turbine generator (WTG) in Subsidiary's Project from being "placed in service" for purposes of the allowance for depreciation under §§ 167 and 168 of the Internal Revenue Code.

FACTS

Taxpayer represents that the facts relating to the request are as follows:

Taxpayer, a State corporation, is the holding company for a number of operating companies engaged in energy related businesses and the parent of a group of affiliated corporations that file a consolidated Federal income tax return on a calendar-year basis. Taxpayer and its affiliates use the accrual method of accounting.

Taxpayer is the parent company of Subsidiary, a regulated public electric utility in State. Subsidiary is developing a wind power generating facility that is referred to as the Project and that will be located in Location. In connection with the Project and several other projects located in State, Subsidiary has acquired easements to over A acres of land in Region on which the Project and several other of Subsidiary's wind farm projects will be constructed and operated. The main components of the Project, which will be owned by Subsidiary, include (i) the wind turbine generators and their attendant parts, and (ii) the electrical gathering facilities.

The wind turbine generators and their respective towers and tower foundations (the WTGs) will be constructed, erected, synchronized to the power grid, and tested before Date 1. Subsidiary intends to enter into a construction contract with a third-party contractor for the design, procurement, and construction of the Project. The construction contract will provide for the construction, installation, and testing of the WTGs. The construction contract also will provide for the construction, installation, and testing of the electrical gathering facilities, including two electrical transformers.

The construction contract will provide that the Project must achieve substantial completion by Date 1, including each WTG successfully passing all critical performance testing by such date. Subsidiary anticipates that each WTG will reach commercial operation by Date 1, meaning a WTG is ready for daily operation, has been connected to the power grid, and is capable of producing and delivering electrical energy to the power grid.

The specific number of WTGs, and the average capacity of each WTG, comprising the Project will be determined when a supplier is selected, which selection will be based principally on a supplier's ability to provide all of the Project's WTGs on a rolling basis with the final WTG to be delivered no later than Date 2. It is anticipated that each WTG will have a nameplate capacity between B and C.

Each WTG will be a self contained unit capable of operating independently of all other WTGs. Each WTG can be started up, tested, commissioned, and synchronized to a power grid separately and independently of all other WTGs. Each WTG will be

connected to the Project's electrical gathering and transmission facilities. Once energized, all of the components that make up each WTG will be tested to insure that each component has been installed properly and is working correctly and that the WTG as a whole is fully functional. Upon completion of the initial tests, a performance test of each WTG, which includes the generation of electrical power and the synchronization to the power grid, will be performed. Successful completion of the performance tests will demonstrate that the WTG is capable of consistently performing its intended function on a routine basis.

It is anticipated that all of the WTGs will be delivered by Date 2, mechanical completion will occur by Date 3, commissioning of WTGs will take place during the period beginning Date 3, and ending Date 4, and the Project as a whole will be substantially complete before Date 1. Commissioning and testing of each WTG will take place as each WTG becomes ready. The construction contract will require that, by Date 1: (1) all necessary permits and licenses with respect to the WTGs will have been obtained; (2) the WTGs will have become synchronized to the power grid for its function of generating electricity for production of income; (3) the critical tests for the various components of the WTGs will have been completed; and (4) the WTGs will have been placed in control of Subsidiary by the contractor. Further, Subsidiary will sell a non-de minimis amount of electricity generated by the Project and each of the WTG's by Date 1.

When State enacted its renewable energy law, Transmitter submitted a plan for additional transmission lines needed to accommodate future wind development projects in Region. Transmitter's project calls for construction of approximately D miles of double circuit, E transmission lines, and F new substations that will serve as the backbone of the system. Transmitter's system, which will be constructed in stages, is designed to meet the identified minimum and maximum wind energy potential of Region and is capable of supporting a maximum capacity of about G. The first segment of Transmitter's system, which affects the Project, is scheduled to be completed in Year 1, but there is a possibility that the line (or critical interconnection facilities to the line that Transmitter is constructing) will not be completed until Year 2.

To deliver power generated by the Project to the power grid, Subsidiary will construct and own a single substation on which two transformers will be adjacent to one another and to the Project. One transformer will step up power to H and interconnect with the Subsidiary Line. The second transformer will step up the power to I and then power will travel along a line of Transmitter to a substation of Transmitter where it will be stepped up to J and then transmitted on the Transmitter Line.

Assuming the Transmitter Line is complete by Date 1, Subsidiary will connect J of the Project's K total generating capacity to the Transmitter Line. With the Transmitter Line and the Subsidiary Line fully operational, strings of specific WTG's will be assigned to a specific transformer in order to match up the appropriate generating capacity.

Subsidiary will commence commercial operations of the Project prior to Date 1, regardless of whether the Transmitter Line has been completed. In the event that the Transmitter Line is not completed by Date 1, Subsidiary will utilize the Subsidiary Line to synchronize each of the WTGs to the power grid as they are completed and to deliver the Project output to the power grid. Although each of the WTGs would be able to produce at its full rated capacity, due to the capacity limitations of the Subsidiary Line, Subsidiary expects to operate a fluctuating number of WTGs in a manner that maximizes operating efficiency depending on the current site specific wind conditions. In periods of low wind, when total generation from the Project's WTGs is less than L, Subsidiary expects to operate all of the Project's WTGs simultaneously. In periods of high wind, when total generation exceeds L, Subsidiary expects to curtail the production of some or all of the WTGs so as not to exceed the L limit. Curtailment at the Project is likely to be undertaken by either pitching blades of individual WTGs to reduce their generation capacity, or, in more extreme wind conditions, disconnecting strings of approximately M to N WTGs from the power grid. In either case, Subsidiary expects that utilization of the Subsidiary Line will allow for delivery and sale of approximately O percent of the Project's full rated capacity. If the Transmitter Line is not completed prior to Date 1, Subsidiary expects to rotate the operation of WTGs during the time prior to completion, so that a reasonably consistent number of operating hours is logged among all of the WTGs for warranty purposes.

Once the Transmitter Line is completed, the interconnection capacity will be sufficient to transmit the maximum output capacity of all of Subsidiary's WTGs at the desired voltage. Subsidiary will connect J of the Project's generating capacity through I Transformer to the Transmitter Line. The remaining L of the Project's generating capacity will remain interconnected through the H transformer to the Subsidiary Line.

RULINGS REQUESTED

Taxpayer requests a letter ruling that the following will not preclude Subsidiary from treating each WTG in its Project as placed in service for purposes of the allowance for depreciation deductions under §§ 167 and 168:

1. The unavailability of the Transmitter Line if Transmitter does not complete its construction prior to Date 1; and
2. The operation of Subsidiary's Project at a maximum level of approximately O percent of its full rated capacity until the Transmitter Line is completed.

LAW AND ANALYSIS

Section 167(a) provides a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income. The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods for determining depreciation allowances. One method is the general depreciation system in § 168(a) and the other method is the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of the general depreciation system, the depreciation method, recovery period, and convention are determined by the property's classification under § 168(e). Section 168(e)(3)(B)(vi)(I) provides that 5-year property includes any property (modifying the language of § 48(a)(3)(A)(i)) that is equipment that uses solar or wind energy to generate electricity.

Section 1.167(a)-11(e)(1)(i) of the Income Tax Regulations provides, in part, that property is first placed in service when first placed in a condition or state of readiness and availability for a specifically designed function. It further provides that the provisions of § 1.46-3(d)(1)(ii) and (d)(2) generally apply for purposes of determining the date on which property is placed in service.

In general, property is placed in service in the taxable year the property is placed in a condition or state of readiness and availability for a specifically designed function. See §§ 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i). Placed in service is construed as having the same meaning for purposes of the investment tax credit under § 46 and depreciation under § 167. Section 1.46-3(d)(2) provides examples of when property is in a condition of readiness and availability. One of those examples is equipment that is acquired for a specifically assigned function and is operational but undergoing tests to eliminate any defects. See also Rev. Proc. 79-40, 1979-1 C.B. 13, where machinery and equipment were placed in service in the year critical tests (with appropriate materials) and operational tests were completed. Another example in § 1.46-3(d)(2) involved operational farm equipment acquired and placed in service in a taxable year even though it was not practical to use such equipment for its specifically designed function in the taxpayer's business of farming until the following year.

Several Tax Court cases have addressed placed in service questions in the context of electric power plants. In Olgethorpe Power Corp. v. Commissioner, T.C. Memo. 1990-505, and Consumers Power Co. v. Commissioner, 89 T.C. 710 (1987), facilities can be deemed placed in service upon sustained power generation near rated capacity. However, if the facility operates on a regular basis but does not produce the projected output, it may still be considered placed in service. Sealy Power, Ltd v. Commissioner, 46 F.3d 382 (5th Cir. 1995), nonacq. 1995-2 C.B. 2. In the Action on

Decision for Sealy Power, the Service stated that at a minimum, the property would have to have been in a state of readiness sufficient to produce electricity on a sustained and reliable basis in commercial quantities. AOD 1995-010. Finally, in Rev. Rul. 84-85, 1984-1 C.B. 10, a solid waste facility that was experiencing operational problems such that it was unable to operate at its rated capacity was nonetheless considered to have been placed in service since it was being operated on a regular basis and saleable steam was being produced. However, if a facility is merely operating on a test basis, it is not placed in service until it is available for service on a regular basis. Consumers Power v. Commissioner, 89 T.C. at 724.

The above-referenced cases and rulings, provide that the following are common factors to be considered in determining placed in service dates for power plants:

- (1) approval of required licenses and permits;
- (2) passage of control of the facility to taxpayer;
- (3) completion of critical tests;
- (4) commencement of daily or regular operations; and,
- (5) synchronization into a power grid for generating electricity to produce income.

See generally Rev. Rul. 76-256, 1976-2 C.B. 46, and Rev. Rul. 76-428, 1976-2 C.B. 47.

The focus in determining a placed in service date is on ascertaining from the relevant facts and circumstances the date the unit begins supplying product in such a manner that it is routinely available and is consistent with the unit's design. It is necessary to examine relevant factors occurring both before and after the claimed placed in service date so that the date can be verified. However, a facility does not have to achieve full design output to be placed in service as long as it is in the process of ramping up its production levels. Subject to exceptions that are beyond the taxpayer's control, the Service has generally required actual operational use as a prerequisite for an asset to be deemed placed in service. See, e.g., SMC Corp. v. United States, 675 F.2d 113 (6th Cir. 1982).

Thus, each WTG is placed in service for depreciation purposes when it is placed in a condition or state of readiness and availability for a specifically assigned function, that is, to produce and deliver electricity generated from wind energy.

Based on the facts provided and applying those facts to the factors delineated in Rev. Rul. 76-256, the Taxpayer represents that prior to Date 1:

- (1) all necessary permits and licenses with respect to the WTGs will have been obtained;
- (2) each of the WTGs will have been synchronized to the power grid for its function of generating electricity for production of income;
- (3) the critical tests for the various components of the WTGs will have been

completed;

(4) the WTGs will have been placed in the control of Subsidiary by the contractor; and,

(5) Subsidiary will sell a non-de minimis amount of electricity generated by the Project and each of the WTGs.

Taxpayer further represents that in the event of a delay in the completion of the Transmitter Line by Date 1, Subsidiary expects to operate a fluctuating number of WTGs in a manner that maximizes operating efficiency given the part load performance characteristics of the WTG and the then current site specific wind conditions. Subsidiary also expects to rotate the operation of WTGs during the time prior to the completion of the Transmitter Line so that a reasonably consistent number of operating hours is logged among all of the WTGs for warranty purposes. This would result in an operating level of approximately Q percent of the Project's full rated capacity.

Daily operation at full rated capacity is not necessary to establish that the WTGs are placed in service. Even without the temporary delivery limitations or curtailments, the site specific wind conditions could dramatically reduce the daily WTG's or the Project's output. As long as the WTGs are ready and available for use and producing commercial output on a regular basis, operating at full rated capacity is not necessary to establish that the WTGs are placed in service. See Sealy Power, supra.

CONCLUSIONS

Accordingly, based solely on the representations submitted by Taxpayer and the applicable law discussion above, we conclude that the following will not preclude Subsidiary from treating each WTG in its Project as placed in service for purposes of the allowance for depreciation deductions under §§ 167 and 168: (1) the unavailability of the Transmitter Line if Transmitter does not complete its construction prior to Date 1; and (2) the operation of Subsidiary's Project at a maximum level of approximately Q percent of its full rated capacity until the Transmitter Line is completed.

The above ruling is expressly conditioned upon Subsidiary otherwise meeting the placed in service factors of Rev. Rul. 76-256 for each of the WTGs before Date 1, and upon the operation of the WTGs in accordance with Taxpayer's representations.

This letter ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer's authorized representative. We are also sending a copy of the letter ruling to the appropriate operating division director.

Sincerely,

KATHLEEN REED

KATHLEEN REED
Chief, Branch 7
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2):
copy of this letter
copy for section 6110 purposes